



STATE BOARD OF EQUALIZATION

STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	Enrolled	Bill No:	SB 451
Tax:	Property	Author:	Ducheny
Related Bills:	AB 1905 (2004) SB 1631 (2002)		

BILL SUMMARY

This bill would specify that rental housing located on leased land on a military base, as specified, is not a possessory interest because it lacks the element of independence.

ANALYSIS

Current Law

Revenue and Taxation Code Section 107 sets forth the three essential elements that must exist to find that a person's use of publicly-owned tax-exempt property rises to a level of a taxable possessory interest. Those elements are independence, durability and exclusivity.

With respect to the element of independence, Section 107(a)(1) defines "independent" to mean "the ability to exercise authority and exert control over the management or operation of the property or improvements, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the property or improvements. A possession or use is independent if the possession or operation of the property is sufficiently autonomous¹ to constitute more than a mere agency."

Relevant case law and Property Tax Rule 20, a regulation, additionally require that a possessor derive "private benefit." "Private benefit" means "that the possessor has the opportunity to make a profit, or to use or be provided an amenity, or to pursue a private purpose in conjunction with its use of the possessory interest. The use should be of some private or economic benefit to the possessor that is not shared by the general public."

Proposed Law

This bill would add Section 107.4 to the Revenue and Taxation Code to provide that a possession or use of land or improvements is **not independent** if that possession or use is pursuant to a contract, including, but not limited to, a long-term lease, for the private construction, renovation, rehabilitation, replacement, management, or maintenance of housing for active duty military personnel and their dependents, if all of the following criteria are met:

Housing

- The housing is on a military facility under military control.
- All services normally provided by a municipality are required to be purchased from the military facility or a provider designated by the military.

¹Property Tax Rule 20 specifies that to be "sufficiently autonomous" to constitute more than a mere agency, the possessor must have the right and ability to exercise significant authority and control over the management or operation of the real property, separate and apart from the policies, statutes, ordinances, rules, and regulations of the public owner of the real property.

Business Operation

- The private contractor is not given the right and ability to exercise any significant authority and control over the management or operation of the military family housing, separate and apart from the rules and regulations of the military.
- The military controls the distribution of revenues from the project to the private contractor.
- The military sets the rents charged for the housing units to military personnel or their dependents.

Occupancy/Access

- The military prescribes rules and regulations governing the use and occupancy of the property.
- Tenants are designated by a military housing agency.
- Evictions from the housing units are subject to the military justice system.
- The military has the authority to remove or bar persons from the property.
- The military may impose access restrictions on the contractor and its tenants.

Initial Construction

- The number of units, the number of bedrooms per unit, and the unit mix are set by the military, and may not be changed by the contractor without prior approval by the military.
- The private contractor is allowed only a predetermined profit or fee for constructing the housing.
- The military approves the financing for the project selected by the contractor/developer.
- The construction of the housing is performed under military guidelines in the same manner as construction that is performed by the military.

An interest that is not “independent” fails to meet one of the three elements that must exist in order for the interest to be subject to property tax. Thus, the housing units would not be subject to property taxation as a possessory interest assessable to the contractor/developer/operator. This bill would also require that any property tax savings as a result of this bill will inure solely to the benefit of the residents of the military housing through improvements such as a child care center provided by the private contractor.

In General

In certain instances a property tax assessment may be levied when a person or entity uses publicly-owned real property that, with respect to its public owner, is either immune or exempt from property taxation. These uses are commonly referred to as “possessory interests” and are typically found where an individual or entity leases, rents or uses federal, state or local government facilities and/or land.

Section 107 establishes parameters within which assessors and judicial authorities are to determine the existence of taxable possessory interests. Generally, those determinations are made according to the facts and circumstances in each individual case.

Background

Much of the existing military housing stock is in poor condition and housing has been identified as a source of retention difficulties faced by the military.

Under the Military Housing Privatization Initiative (MHPI) Act authorized by Congress in 1996, the military has started to privatize on-base family housing units. The specifics of the implementation plans developed by the Army; Air Force, Navy, and Marine Corps plans vary. However, the basic frameworks for these plans are similar:

- Lease military base land to private contractor/developer for 50 years.
- Convey existing family housing units and infrastructure to the contractor/developer for replacement or renovation.
- Contractor/developer to build additional family housing units, as required.
- Contractor/developer will assume responsibility for property management, including repairs and maintenance.
- Tenant costs including utilities may not exceed basic allowance for housing (BAH).
- At the end of the contract, ownership of the housing units will revert to the military authority.

The Military Housing Privatization Initiative is managed by the Competitive Sourcing and Privatization (CS&P) Office, in the Office of the Deputy Under Secretary of Defense (Installations and Environment). The Department of Defense maintains an extensive Web Site on the program at <http://www.acq.osd.mil/housing/>.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by De Luz Family Housing. The author's background sheet explains the purpose of the bill as follows:

PROBLEM: As a result of the long-term lease, which is necessary for the contractor to obtain financing, under the current interpretation of California law a possessory interest is created. This interest is taxable in the same manner as privately held property. The taxes, which can be substantial, reduce the amount of revenue from the project and hence reduce both the construction funds that can be financed and the funds necessary for maintenance. This appears to be an unintended consequence of the MHPI. The result is that contractors will not be able to build housing units to as high a standard as they otherwise would. And maintenance funds will suffer threatening the quality of life of residents.

SOLUTION: The solution is to clarify existing law as to the definition of possessory interest. In order for a possessory interest to be created it must be deemed to be independent, durable and exclusive. While it can be argued that the interest created under the MHPI is none of these, the courts have said that legislative clarification is needed. Currently, based on an earlier military leasing act (Military Leasing Act of 1947), the courts are considering such interests to be taxable. This bill redefines "independence" under the definition of "possessory interest" to specifically address situations where the military has primary control over the project.

Additionally, the author states that this bill would not harm local government finances because, with respect to the existing housing stock that has been conveyed to private developers and will be replaced or renovated, that housing stock was not previously subject to property tax when owned directly by the military. With respect to the impact of new housing, the author states that local governments will not be negatively impacted because emergency services will be provided by the military base and schools would be compensated by Federal Impact Aid. The author states that, in fact, on-base housing will likely result in a positive impact to local

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governments because of reduced traffic congestion and reduced demand for other public services (police, fire, emergency medical, housing subsidies, etc.) by having fewer military families living off base.

2. **Key Amendments.** The **August 17, 2004** amendments specify that these provisions apply only to MHPI properties and adds uncodified legislative intent language. The **June 26, 2003** amendment provides that if the amount of property tax reduction resulting from this bill is unknown, the private contractor may make a reasonable estimate of savings in ensuring that the property tax exclusion will inure to the residents of the military housing. This bill relates to property that is currently subject to tax in San Diego County and the property tax due is known. However, this bill may also apply to housing constructed in the future, and the amendment is intended to ensure that the assessor is not required to value the property for the purpose of determining the amount of property taxes that would be levied absent the exclusion that this bill creates. The **June 3, 2003** amendment requires that any reduction in property taxes on leased property used for military housing under the MHPI will inure solely to the benefit of the residents of the military housing through improvements, such as a child care center provided by the contractor. As introduced, this bill would not have required that any property tax savings generated would have ultimately inured to the benefit of the military personnel living in the residences. Other sections of law extending a property tax exemption to an otherwise non-tax exempt entity require that property tax savings inure to the worthy organization in question. See for example, Section 206.2 related to property leased to churches and Section 202.2 for property leased to free libraries and museums. The June 3 amendment also deletes an amendment made on April 21 to provide that the addition of Section 107.4 does not constitute a change in, but is declaratory of, existing law. Presumably, this would have resulted in a refund of property taxes previously paid by De Luz Family Housing. The **April 21, 2003** amendment also made several other nonsubstantive changes.
3. **To date, four projects under the Military Housing Privatization Initiative have been awarded and one is pending approval in California. In addition, there are potentially six more projects to be awarded in California.**

The awardee/developer/general partner of the projects have been

- Hunt Building Corp. (El Paso, Texas) for Camp Pendleton, Phase 1
 - Location: San Diego County
 - Status: Possessory Interest Assessed, Taxpayer Appealed, Assessment Appeals Board upheld assessment.
- Lincoln Property Co. (Dallas, Texas) and Clark Realty Capital (Bethesda, Maryland), LLC for the Naval Complex San Diego.
 - Location: San Diego County
 - Status: Possessory Interest Assessed, Taxpayer Appealed on valuation issues, but not on the issue that the possessory interest was improper.
- The U.S. Army, U.S. Navy, and Clark Pinnacle Family Communities, LLC² have formed a **public-private partnership** (the Monterey Bay Military Housing LLC- the members of which are the U.S. Secretary of the Army on behalf of the Departments of the Army and Navy and Clark Pinnacle LLC) to operate and

² Clark Pinnacle Family Communities, LLC is a joint venture between Clark Construction Company (Bethesda, Md) and Pinnacle Realty Management (Seattle, Washington).

construct military family housing communities for the Presidio of Monterey and the Naval Postgraduate School in Monterey Bay, California.

- Location: Monterey County
 - Status: Board of Equalization legal staff reviewed the proposed contracts in April 2003 and opined that under the specific circumstances of the contract, an agency relationship exists between the federal government and the LLC. As an agent of the federal government, the LLC lacks the independence necessary to have a taxable possessory interest.
 - The U.S. Army and Clark Pinnacle Family Communities, LLC have formed a **public-private partnership** to construct, renovate, and operate military family housing communities at Fort Irwin (San Bernardino County), Moffett Airfield (Santa Clara County), and Parks Reserve Forces Training Area (Alameda County).
 - An award for the Beale Air Force Base is pending.
 - Location: Yuba County
 - Status: Not yet constructed.
4. **San Diego County has assessed a possessory interest in the Camp Pendleton project (De Luz Family Housing).** De Luz filed an appeal and the San Diego Assessment Appeals Board found that a taxable possessory interest exists. It is unknown if the taxpayer will file suit in Superior Court. In addition, San Diego County has also assessed a possessory interest in the Naval Complex San Diego project. That taxpayer also filed an appeal, but only on the issue of valuation.
5. **According to the Department of Defense, the property tax implications of these projects are not guaranteed.** The website to potential bidders notes: “Are property taxes considered in these deals? Although DoD will not negotiate with the local jurisdiction on any tax abatements, the developer is free to negotiate to achieve any tax abatements.” <http://www.acq.osd.mil/housing/faqs.htm#27>
6. **The original construction of the De Luz homes in the early 1950’s was the focus of a landmark California Supreme Court decision on the valuation method applied to possessory interests: *De Luz Homes, Inc. v. County of San Diego*, (1955) 45 Cal.2d 546.** In 1949, Congress approved the Wherry Housing Program that was intended to bring private homebuilders into the rental housing market for military personnel without using military construction funding. The original De Luz homes were constructed under this program. Under the program, a developer acquired a land lease in 1952 and built housing rented to military families at Camp Pendleton which was subsequently subject to property taxation as a possessory interest. The *De Luz* possessory interest case was not about whether the developer had a taxable possessory interest in the property in the first instance, but rather how to properly value the possessory interest. Apparently, congressional concerns with “windfall” profits accruing to private developers under the program led to its effective termination in 1955, and beginning in 1957 the military began purchasing the homes constructed by private developers under the program. Thus, because Wherry housing was eventually purchased by the military (which is immune from state-imposed property tax), the military housing built under that program, including the De Luz homes, have not been subject to property tax in California until the 2000 conveyance to a private developer under the 1996 Military Housing Privatization Initiative program. See CRS Report for Congress, “Military Housing

Privatization Initiative: Background and Issues, July 2, 2001: <http://www.acq.osd.mil/housing/docs/crs.pdf>.

7. **Other privately owned military housing on leased military property is currently subject to a possessory interest tax.** Since 1991, Ventura County has levied a possessory interest tax on the private contractor for 300 military residential housing units available for rent to military personnel on land leased by the Navy at Port Hueneme, California. This housing was built under the Section 801 Housing Program (a build-to-lease guarantee to the property developer) approved by Congress in 1984. In addition to the recent taxation of a possessory interest in San Diego County and the possessory interest in Ventura County, other counties may also have been assessing possessory interests in other privately-operated military housing located on military bases.
8. **Independence.** To qualify as a possessory interest, the right to use property must be sufficiently exclusive, durable and independent of the public owner to constitute **more than an agency**. *Pacific Grove-Asilomar Operating Corp. v. County of Monterey* (1974) 43 Cal.App.3d 675, 684. "If, in practical effect, one of the parties has the right to exercise complete control over the operation, an agency relationship exists;..." (*Nichols v. Arthur Murray, Inc.* (1967) 284 Cal. App.2d, 610, 6B). *Pacific Grove-Asilomar Operating Corp* is a nonprofit corporation organized under the laws of the State of California solely for the purpose of managing for and on behalf of the California Department of Parks and Recreation the real property and all improvements on the "Asilomar Conference Grounds." In the *Pacific Grove* case, the Court found that an agency was created by the agreement there in question; the court concluded that Asilomar's management of the property was not independent, but subject to state control in every way. To date, that decision appears to be one of the few possessory interest cases in which an appellate court has concluded that an agency relationship existed.
9. **If it is determined that the contractor's interest rises to the level of a taxable possessory interest, then any restrictions, such as the restrictions on the rent that may be charged, must be reflected in the value of the possessory interest.** Section 402.1 provides that in the assessment of land, the assessor must consider the effect upon the value of any enforceable restrictions to which the use of the land may be subjected. For instance, the military will restrict the contractor's use and possession of the land and improvements and will restrict the contractor's right to set rental fees on the land and the improvements. These restrictions must be considered by the assessor in valuing the land and improvements. See BOE Annotated Letter 660.0171: http://www.boe.ca.gov/proptaxes/pdf/660_0171.pdf
10. **Prior Constitutional Considerations.** Legislation to exempt various possessory interests by statute has been often argued to be an "unconstitutional" exemption of real property. It is claimed that the appropriate course of action is to instead seek the approval of the voters of California by proposing a constitutional amendment to exempt the particular class of real property from property taxation. Therefore, some may argue that this legislation, if enacted, would similarly constitute an "unconstitutional" exemption of real property. However, in *City of San Jose v. Carlson* (1997) 57 Cal.App. 4th 1348, the court acknowledged the appropriateness of Legislative action to set parameters on the element of durability. A similar rationale could be made for this bill, with respect to the element of independence. The Sixth District Court of Appeals in *City of San Jose* invited the Legislature to establish some statutory standards in measuring durability. The court stated:

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“Although we agree that the element of durability seems to have been ‘diluted to a degree of almost nonexistence’ (*United Airlines, Inc. v. County of San Diego* (1991) [cite omitted]), the Legislature has not seen fit to reverse the growing trend toward finding taxable possessory interests in short-term uses, even in its most recent amendments to Section 107. If there is a sound basis for distinguishing between a second time user and a third time user of government-owned property for purposes of identifying a taxable possessory interest, **it is within the province of the Legislature to clarify the parameters of that interest in terms of frequency, duration, and length of time between uses.**” [Emphasis added.]

11. **The MHPI provides advantages for the military and provides venture capital opportunities for the private sector. There is a private or economic benefit to the private sector developers that ultimately seek and win the contract to build, rehabilitate, and manage the housing units on military bases. The Department of Defense(DOD) notes:** Advantages for the Military, Venture Capital Opportunities for the Private Sector MHPI promotes a mutually beneficial relationship between DoD and the private sector. For DoD, it results in the construction of more housing built to market standards for less money than through the military construction process. Commercial construction is not only faster and less costly than military construction, but private-sector funds significantly stretch and leverage the DoD’s limited housing funds. Developers and financiers can find significant venture capital opportunities in DoD housing. Privatization opens the military construction market to a greater number of development firms. MHPI stimulates the economy through increased building activity, and MHPI projects can provide a long-term continuous inflow of capital to an investor. <http://www.acq.osd.mil/housing/overview.htm>
12. **This bill requires that any reduction in property taxes on leased property used for military housing under the MHPI will inure solely to the benefit of the residents of the military housing through improvements, such as a child care center provided by the contractor.** Other sections of law extending a property tax exemption to an otherwise non-tax exempt entity require that property tax savings inure to the worthy organization in question. See for example, Section 206.2 related to property leased to churches and Section 202.2 for property leased to free libraries and museums.
13. **This bill provides that if the amount of property tax reduction resulting from this bill is unknown, the private contractor may make a reasonable estimate of savings in ensuring that the property tax exclusion will inure to the residents of the military housing.** This bill relates to property that is currently subject to tax in San Diego County and the property tax due is known. However, this bill may also apply to housing constructed in the future, and the amendment is intended to ensure that the assessor is not required to value the property for the purpose of determining the amount of property.
14. **If this bill passes and the possessory interest held by the developer/operator is exempt from property tax, the military personnel that live in homes would not subsequently be directly assessed a taxable possessory interest.** Some governmental employees who reside in tax-exempt governmentally-owned property, (for example forest service employees), receive direct possessory interest assessments. However, active duty military personnel are not subject to such

taxable possessory interests. In 1980, the 9th Circuit Court of Appeals in *United States v. Humboldt County* 628 F.2d 549 held that the occupancy of rent-free housing to military personnel on base at Beale Air Force Base in Yuba County and off-base near Centerville Beach Naval Facility in Humboldt County was not durable, nor did it confer a private benefit to the military personnel, and thus not a taxable possessory interest.

15. Related Legislation. Similar legislation was contained in this year's AB 1905 (Parra) which was held in the Assembly Appropriations Committee and in SB 1631 (Morrow) in 2002, which did not pass out of the Senate Revenue and Taxation Committee.

COST ESTIMATE

The Board would incur insignificant costs (less than \$10,000) in informing and advising county assessors, the public, and staff of the change in law.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Under the Military Housing Privatization Initiative (MHPI) Act authorized by Congress in 1996, the military has started to privatize on-base family housing units. Although the specifics of the implementation plans developed by the Army, the Air Force, and the Navy including the Marine Corps vary, the basic framework of their deals are very similar and include:

- Lease military base land to private contractor/developer for 50 years.
- Convey existing family housing units and infrastructure to the contractor/developer for replacement or renovation.
- Contractor/developer to build additional family housing units, as required.
- Contractor/developer will assume responsibility for property management, including repairs and maintenance.
- Tenant costs including utilities may not exceed basic allowance for housing (BAH).
- At the end of the contract, ownership of the housing units will revert to the military authority.

Under this bill, MHPI projects meeting certain criteria would not be treated as taxable possessory interests.

According to the DOD, the privatization projects awarded or in planning for California are:

Branch	Project	Scope	Award Date
Marine	Camp Pendleton (Phase I)	712 housing units	November 2000
Navy	Naval Complex San Diego (Phase I)	3,248 housing units	August 2001
Army	Presidio of Monterey <i>POM</i> <i>Ord Military Community</i> Naval Postgraduate School	2,209 housing units	October 2003
Army	Fort Irwin Fort Irwin Moffett Federal Airfield Camp Parks	3,052 housing units	March 2004
Air Force	Beale AFB	1,344 housing units	June 2004
Navy	Naval Complex San Diego (phase 2)	3,217 housing units	May 2003
Navy	Naval Complex San Diego (phase 3)	2,668 housing units	February 2005
Marine	Camp Pendleton (Phase 2)	3,300 housing units	September 2003
Marine	Camp Pendleton (Phase 3) (pending approval from DOD)	4,577 housing units	September 2006 (projected)
Marine	Twenty-nine Palms (pending approval from DOD)	1,382 housing units	September 2005
Air Force	Travis AFB (pending approval from DOD)	1,413 housing units	March 2006
	TOTAL	27,122 housing units	completed by 2010

The De Luz family housing area in Camp Pendleton was privatized in November 2000. According to the San Diego County Assessor's Office, the total assessed value for the taxable possessory interest for the 712 existing housing units and new units amounted to \$35 million. Families started moving into some of the 200 homes being built in the area in October 2001. The new homes that were completed in 2001, along with the Naval Complex San Diego project, comprising 3,248 housing units, were assessed as possessory interests on the 2002 roll. However, the housing units in the Naval Complex San Diego projects utilize city and county emergency services and will continue to be treated as taxable possessory interests under this proposal.

For the purposes of this estimate, the initial valuation of the possessory interest for the De Luz/Pendleton homes will be used to estimate the valuation and revenue impact of all of the privatization projects currently planned for California. The average assessed value per privatized housing unit is \$35 million/ 712, or \$49,000.

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The revenue impact for the De Luz/Pendleton homes can be estimated as follows:

$$712 \times \$49,000 = \$35.0 \text{ million} \quad \times 1\%, \quad = \$350,000$$

Since the ownership of the property in the two Army projects remains in the federal government and the property is therefore immune from property taxation, housing units in the Army projects—Fort Irwin and Presidio of Monterey including the Naval Postgraduate School—will not be affected by this bill.

The maximum number of housing units that would be affected by this bill is then :

Camp Pendleton (Phase I & 2) + Beale AFB

or

$$712 + 3,300 + 1,344 = 5,356$$

The annual revenue impact in 2005 can be estimated:

	Estimated AV		Property tax at 1% tax rate
5,356	$\times \$49,000 = \262.4 million	$\times 1\%$	\$2.62 million

Revenue Summary

The annual revenue impact at the basic one percent property tax rate under this bill is estimated to be \$2.62 million by 2005.

Assuming that this bill would first be effective for the 2004 lien date, the number of housing units that would be affected in the first three years can be estimated as follows:

Year	Projects
2004	DeLuz/Pendleton 712
2005/2006	2004 + Pendleton, Phase II + Air Force $712 + 3,300 + 1,344 = 5,356$

Year	Estimated AV		Property tax at 1% tax rate
2004	\$35.0 million	$\times 1\%$	\$350,000
2005/2006	$5,356 \times \$49,000 =$ \$262.4 million	$\times 1\%$	\$2.62 million

Qualifying Remarks

This estimate measures the impact for the military housing privatized under the MHPI only. There are other housing projects that could be affected by this bill. For instance, the possessory interest in Ventura County has an assessed value in 2002 of roughly \$19.5 million resulting in property taxes of \$195,000 at the 1% tax rate.

The impact of this bill may be smaller if any additional housing units currently scheduled for privatization under MHPI utilize city or county services or are not situated on a military base under the control of the military, or if the contractor for any of the other projects is an agent of the federal government, as was found in the case of the Army projects.

MHPI deals only with the privatization of family housing units. Depending on the success of the MHPI privatization plans, the military may decide to privatize bachelor-housing quarters as well. The revenue impact of this bill would increase significantly if bachelor housing quarters were privatized.

As of March 2004, the DOD has three other MHPI California projects awaiting approval by of Office of the Secretary of Defense. They are the Marine Corp Facility at Twenty-nine Palms, with 1382 housing units, Travis Air Force Base, with 1413 housing units, and Camp Pendleton Phase 3, with 4577 housing units. The assessed value for these three projects adds up to \$361.2 million (7372 x \$49,000) resulting in property taxes of \$3.6 million at the 1% tax rate.

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